**TESTIMONY OF ROBERT GREENSTEIN**
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**before the**
**Senate Budget Committee**
**August 2, 2001**

I appreciate the invitation to appear before you today. I am Robert Greenstein, executive director of Center on Budget and Policy Priorities. The Center is a policy institute that focuses on fiscal policy issues and has a particular interest in the effects of government policies on low- and moderate-income families.

My testimony focuses on the Social Security financing shortfall and how the magnitude of that shortfall compares to the size of the recently enacted tax cut. The testimony also looks at the role of policies to wall off the Social Security reserves and devote them to debt reduction.

## Social Security's Financing Problems

The Social Security commission appointed by President Bush argues in its recent draft interim report that Social Security faces financial difficulties starting in 2016 because the program's benefit costs will begin to exceed its tax revenue in that year. As a number of economists, fiscal policy experts, and Social Security experts have explained, Social Security itself does not face financial difficulties in 2016, because the Social Security Trust Fund will hold $5 trillion in bonds at that point and the interest on those bonds will cause Social Security still to be in surplus.[1] But as the baby boomers retire in large numbers, increasing Social Security and Medicare costs will place growing pressure on the rest of the budget. And in 2038, the Social Security Trust Fund will be exhausted.

Social Security's long-term financing problems have several dimensions to them. The increase in Social Security and Medicare costs as the population ages will place pressure on the rest of the budget before 2038. In addition, since it is inconceivable politically that Social Security benefits will be reduced and/or payroll taxes raised sufficiently to restore long-term solvency solely through such steps, additional resources are virtually certain to be needed as part of any politically viable reform package that restores long term Social Security solvency. This is true regardless of whether a reform plan either includes individual accounts or provides for investment of a portion of the Social Security Trust Fund in equities.

Restoring long-term solvency to Social Security and ensuring a sustainable long-run fiscal policy for the United States are issues of major importance. To help illuminate these issues, our Center has just completed an analysis examining the fiscal dimensions of two major items: the projected long-term deficit in Social Security and the long-term cost of the recently enacted tax

[1] Henry J. Aaron, Alan S. Blinder, Alicia H. Munnell, and Peter R. Orszag, "Perspectives on the Draft Interim Report of the President's Commission to Strengthen Social Security," Center on Budget and Policy Priorities and The Century Foundation, July 23, 2001. Also see the response from Aaron, Blinder, Munnell, and Orszag to the co-chairs of the commission, Center on Budget and Policy Priorities and The Century Foundation, July 24, 2001.

cut (assuming that the provisions of the tax cut are extended beyond their scheduled expiration dates).

If one listens to some pundits and policymakers, the tax cut is modest on size while the long-term Social Security shortfall is enormous. But such statements cannot both be true. The size of the tax cut is *more than double* the entire long-term Social Security shortfall. The tax cut is not as modest as some of its proponents claim, while the Social Security shortfall — although surely a significant problem that must be addressed — is not as gargantuan as it is sometimes portrayed as being, especially by some who seek radical changes in Social Security.

## The Size of the Tax Cut and the Social Security Shortfall

According to the official estimates that the Social Security actuaries and trustees issued in March 2001, the projected long-term deficit in Social Security over the next 75 years — the period used for measuring long-term solvency — equals 1.86 percent of the wages, salaries, and self-employment income that will be subject to the payroll tax during this period, or $3.2 trillion in present value. (Present value is the amount today that, with interest, would exactly cover these future costs.) The trustees' report also shows that, measured as a share of the economy, the Social Security shortfall equals 0.7 percent of the Gross Domestic Product over the next 75 years.[2]

To measure the long-term cost of the tax cut, we take the Joint Tax Committee's estimate of the cost of the tax cut in 2011 if all of its provisions are extended, and assume that these costs will remain constant as a share of GDP after 2011. Assuming that the cost of tax cuts will remain constant as a share of GDP once the tax cuts are fully in effect is the standard approach that the Congressional Budget Office, the Office of Management and Budget, and the General Accounting Office all use when preparing long-term fiscal projections. In this case, such an approach is likely to understate the long-term revenue loss because the costs of several provisions of the tax bill such as estate tax repeal and the introduction of "Roth 401(k) pension plans" are virtually certain to grow faster than GDP for a number of years after 2011.[3] For this reason, our estimates of the long-term costs of the tax cut are likely to be conservative.

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[2] Under the Social Security actuaries' intermediate projections, the projected 75-year deficit amounts to 1.86 percent of taxable payroll. Over this 75-year-period, taxable payroll will amount to 37.6 percent of the Gross Domestic Product when both are expressed in present value. As a result, the 75-year imbalance amounts to 0.7 percent of GDP, which is equal to 1.86 percent multiplied by 37.6 percent.

[3] The assumption that the tax cut will remain a constant share of GDP after 2011 is likely to be conservative. Before the tax cut was enacted, both income tax revenues and estate tax revenues were projected to grow somewhat faster than the economy. This growth was projected to occur primarily because national income is projected to grow faster than inflation (with the result that income growth would push some taxpayers into higher marginal tax brackets even though the brackets are indexed to inflation), and because the amount exempt from the estate tax was not indexed for inflation. In addition, some provisions of the tax legislation, such as the creation of the Roth 401(k) and the increase in the amount that can be contributed to a Roth IRA, are substantially more costly in the long run than in the short run.

| Cost of Tax Cut and Size of Social Security Shortfall Over 75 Years | | |
|---|---|---|
| | **As Share of GDP** | **Present Value** |
| Social Security Shortfall | 0.7% | $3.2 trillion |
| Tax Cut | 1.6% | $7.7 trillion |

The projected cost of the tax cut over 75 years amounts to 1.6 percent of GDP, or $7.7 trillion in present value. Thus, the cost of the tax cut over the next 75 years is more than twice as large as the long-term deficit in Social Security.

In other words, if the tax cuts take effect as scheduled and continue after 2010, their long-term cost will substantially exceed the long-term *benefits* to the budget of eliminating the entire 75-year deficit within Social Security. Moreover, if the tax cut were scaled back so that three-fifths of it took effect while the funds from the other 40 percent of the tax cut were used instead to strengthen Social Security, the entire long-term deficit in Social Security could be eliminated. Such a course would not require tax increases, but rather that the tax cuts ultimately not be as deep as the recent tax-cut legislation envisions.

I should emphasize that I am not recommending canceling 40 percent of the tax cut and placing all of the freed-up resources in Social Security. The nation will face serious financial strains when the baby boomers retire in large numbers. The long-term financing shortfall in Medicare is larger than that in Social Security, and the nation also is likely to face needs in the decades ahead that will require resources in other areas, including areas relating to children, the environment, and the large number of Americans without health insurance, as well as other problems that inevitably will arise in the future but that we cannot foresee today. A balanced long-term fiscal policy is likely to entail some changes in Social Security to reduce its future claims on the budget, rather than simply providing it with whatever level of resources is needed from the rest of the budget to close its entire long-term financing shortfall.

Providing resources from the rest of the budget to close a *portion* (rather than all) of the Social Security shortfall, however — in conjunction with other Social Security reforms — is likely to be essential if any reform plan to restore long-term solvency is to have hope of being enacted. Otherwise, the Social Security benefit cuts and/or payroll tax increases that will be required as part of any solvency plan are likely to be too large for such a plan to be politically viable.

The relative magnitudes of the long-term deficit in Social Security and the long-term revenue loss resulting from the tax cut highlight an important question: Given the demographic and other challenges that lie ahead, was a tax cut that ultimately will provide approximately 35 percent of its benefits to the most affluent one percent of the population the best use of the bulk of the surplus projected outside Social Security and Medicare Hospital Insurance? The figures on the relative size of the Social Security shortfall and the tax cut also show the fundamental inconsistency in the rhetoric of those who portray Social Security as facing an enormous financial chasm that threatens the nation's long-term fiscal health while touting the tax cut as modest and prudent.

As alluded to above, the tax cut is likely to make Social Security reform considerably more difficult, if not impossible, for the foreseeable future. The tax cut consumes non-Social Security resources that are likely to be essential to the development of a politically viable package of reforms to restore Social Security solvency.

Transfers from the non-Social Security budget are likely to be crucial to the political viability both of Social Security plans that include individual accounts and of plans that do not. Without such transfers, individual accounts will have to be financed from existing Social Security revenue. Diverting revenue from the Social Security Trust Fund into individual accounts, however, would exacerbate Social Security's projected long-term deficit by reducing the revenue available to the system. Restoring long-term balance to the Social Security system while shifting revenue from the Trust Fund to individual accounts requires larger reductions in Social Security benefits (relative to the benefits that would be paid under the current-law benefit formula) than otherwise would be needed.

A recent analysis by four leading economists and Social Security experts — Henry Aaron, Alan Blinder, Alicia Munnell, and Peter Orszag — found that if payroll tax revenues equaling two percent of wages were shifted from Social Security to individual accounts and Social Security benefits were maintained at current-law levels for people currently 55 and older, Social Security benefits for workers 30 and under would have to be cut more than 50 percent.[4] Including the income from individual accounts, the overall retirement income for such workers (their reduced Social Security benefits plus the retirement income they would receive from the individual accounts) would average 20 percent below current-law levels (with some workers losing considerably more than that) *if* stock market returns were as high in future decades as promoters of private accounts predict. As these figures suggest, the magnitude of the reductions in Social Security benefits that would be necessitated by action to create individual accounts *without* securing additional revenue from the non-Social Security budget is likely to doom individual account plans that lack another revenue source.

In short, regardless of whether Social Security reform includes individual accounts, transfers from the non-Social Security budget are almost certain to be essential to the development of a politically acceptable reform plan. Such transfers are not likely to be possible without creating deficits outside the Social Security and Medicare Hospital Insurance trust funds, unless the tax cut is modified rather than extended in its current form.

The next section of this testimony explains in more detail the projections of the relative sizes of the long-term deficit in Social Security and the revenue loss from the tax cut.

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[4] Henry J. Aaron, Alan S. Blinder, Alicia H. Munnell, and Peter R. Orszag, "Governor Bush's Individual Account Proposal: Implications for Retirement Benefits," The Century Foundation and the Social Security Network, June 6, 2000.

## The 75-year Deficit Within Social Security

As is well known, Social Security currently owns assets — Treasury bonds backed by the full faith and credit of the U.S. government — totaling more than $1 trillion. In addition, Social Security is currently running annual surpluses of roughly $150 billion, and these surpluses are expected to increase in size for a number of years. According to the current projections of the Social Security Trustees, annual Social Security tax revenue (which does not include interest on the bonds the Trust Fund holds) will fall below Social Security benefit expenditures starting in 2016, but Social Security as a whole will run a surplus of more than $250 billion in 2016 because it will earn interest income on the bonds it holds. The Trustees expect Social Security to remain in surplus until 2025, even with the increase in the cost of benefits that will occur as a growing share of the "baby boom" generation retires. At that time, the Trust Fund's assets will total $6.5 trillion (or $3 trillion if measured in today's dollars).

The Social Security actuaries calculate, however, that those assets, along with the interest on them and future Social Security revenue, will be insufficient to cover all of Social Security's future costs. Over the 75-year period used for long-term Social Security planning, the shortfall is projected to be $3.2 trillion.[5] In other words, if Social Security currently had $4.3 trillion in assets rather than $1.1 trillion, projected revenues plus its expanded reserves would cover projected costs for the next 75 years.

Another measure of the long-term deficit under Social Security is that the system faces a projected 75-year imbalance equal to 0.7 percent of the Gross Domestic Product. In other words, if Social Security had additional revenue equal to 0.7 percent of GDP each year, its 75-year deficit would be eliminated.

## The 75-year Cost of the Tax Cut

Budget policies are not commonly discussed in terms of their costs over 75 years, in part because the resulting figures would be mind-numbing. But it is instructive to do so, given the concerns over the long-term health of the federal budget that are being emphasized in the Social Security debate.

To calculate the long-term costs of the tax cut, we use estimates of the tax cut supplied by the Joint Committee on Taxation (JCT), the official tax estimator for Congress. The tax cut includes several provisions that expire before 2010, and all of its other provisions expire in 2010. Administration officials and other prominent supporters of the tax cut have made clear, however, that they expect the tax cut to continue. The JCT estimates used here show the costs that will

[5] Office of the Chief Actuary, "Unfunded Obligations and Selected Transition Costs for the Combined Old-Age and Survivors Insurance and Disability Insurance (OASDI) Programs," April 5, 2001. The $3.2 trillion is the net present value of the 75-year deficit.

**The Deficit Within Social Security and the Cost of the Tax Cut, Measured in Perpetuity**

It also is possible to examine the size of the deficit in Social Security in perpetuity and the cost of the tax cut in perpetuity. Such a comparison can be made by using the same methodology as described here to estimate the permanent cost of the tax cut, and by using figures from the Social Security actuaries to estimate the permanent Social Security deficit. In both cases, the projection horizon is extended far beyond 75 years.

Calculations of costs in perpetuity are subject to even more uncertainty than the already-uncertain estimates for 75 years, or even for 10 years. Birth, death, and productivity rates a century or several centuries from now are highly speculative. I would not recommend basing analyses or making policy decisions on estimates of costs in perpetuity. (I discuss costs in perpetuity here because some proponents of Social Security privatization have said that Social Security faces a $12 trillion shortfall but claimed the tax cut is much smaller.)

The Social Security actuaries have estimated that the present value of the cost of transforming Social Security from a primarily pay-as-you go system to a fully funded system would amount to $11.7 trillion.* This cost is approximately equal to the projected deficit in Social Security in perpetuity.** (This $11.7 trillion figure also is the cost that would have to be paid to transform Social Security fully into a system of individual accounts.)

The cost in perpetuity of the recently enacted tax cut (estimated as above, but extending the analysis beyond 75 years) equals $11.8 trillion. Shifting the focus beyond 75 years thus does not alter the basic finding of this analysis: the long-term cost of the tax cut is at least as large as the long-term deficit in Social Security.

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* Office of the Chief Actuary, "Unfunded Obligations and Selected Transition Costs for the Combined Old-Age and Survivors Insurance and Disability Insurance (OASDI) Programs," April 5, 2001.

** For further discussion of the connection between the cost of transforming Social Security to a fully funded system and the deficit in Social Security in perpetuity, see John Geanakoplos, Olivia S. Mitchell, and Stephen P. Zeldes, "Social Security's Money Worth,"in Olivia S. Mitchell, Robert J. Myers, and Howard Young, *Prospects for Social Security Reform* (University of Pennsylvania Press: Philadelphia, 1999).

occur in 2011 if the provisions are made permanent law. The JCT supplied these estimates to Congress on June 20, 2001.[6]

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[6] The JCT estimates, provided to Rep. Charles Rangel, include costs relating to extension of a provision of the tax law scheduled to expire in 2004 that provides relief from the Alternative Minimum Tax. Through 2004, this provision holds the number of taxpayers subject to the AMT to roughly the number that would have been subject to the AMT under the law in place prior to enactment of the new tax legislation. In preparing its estimate of the cost of the tax cut legislation in 2011 with the various provisions extended, the JCT assumed continuation of this provision in such a manner that the number of taxpayers subject to the AMT would continue to track closely the number of taxpayers who would have been subject to the AMT under prior law. (This approach almost certainly understates the ultimate cost of addressing problems in the AMT, since under the prior law and hence under the JCT estimates used here, the number of taxpayers subject to the AMT still would rise from about 1.5 million in 2001 to more than 20 million in 2011.) The estimate used here for the cost of the tax cut does *not* include the cost of extending an array of

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To project the cost of the tax cut beyond 2011 (the last year for which JCT estimates are available), we assume it will remain a constant share of the economy thereafter. Based on the conservative assumption that the tax cut will remain a constant share of the economy from 2011 on, the cost of the tax over the next 75 years amounts to 1.6 percent of GDP over that period.[7] In dollar terms, the long-term cost of the tax cut amounts to $7.7 trillion in present value.[8] The cost of the tax cut thus is more than twice as large as the long-term deficit in Social Security, which amounts to 0.7 percent of GDP, or $3.2 trillion.

## How a Social Security Lockbox Helps

As this testimony indicates, restoring long-term Social Security solvency is likely to entail both a combination of benefit and/or tax changes in Social Security and a transfer of funds from the general fund to Social Security. Preserving Social Security's cash-flow surpluses and using them to pay down debt also plays a role; it helps the nation to afford the provision of adequate Social Security benefits.

The draft interim report of the Social Security commission suggests Social Security faces serious financial problems starting in 2016, when the cost of the benefits that Social Security pays will begin to exceed the tax revenue it receives. As many analysts have explained in the past few weeks, Social Security does not itself face problems in 2016 because it will have accumulated $5 trillion in assets in the form of U.S. Treasury bonds. In fact, the Social Security Trustees project that the Social Security Trust Fund will receive more than $300 billion in interest payments on these bonds in 2016 and actually will run a *surplus* of more than $250 billion that year.

*Total* Social Security income — including the interest the Trust Fund earns on its bonds — will start to fall below Social Security expenditures in 2025. At that point, the Trust Fund will begin to redeem its bonds. All of these bonds will have been redeemed by 2038, at which point the Trust Fund will not be able to pay full benefits.

These realities have led a number of commentators to ask: if Social Security will continue paying full benefits between 2016 and 2038 because of the interest it will earn on its bonds and the proceeds it will later receive from redeeming the bonds, where will the rest of the government secure the funds to make these interest payments and ultimately to buy back the

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[6] (...continued)
popular tax credits that are regularly extended for a few years at a time and are virtually certain to continue being renewed. That cost is not included here because the recently enacted tax law does not address the issue of extending these credits.

[7] In conducting this analysis, we used the actuaries' estimates of GDP in calculating the amount of the tax cut to assure consistency in our cost estimates.

[8] The $7.7 trillion is the net present value of the tax cut over the next 75 years, discounted at the same discount rate as the Social Security actuaries use to compute the 75-year deficit in Social Security.

bonds? Part of the answer is the large savings the government will realize in interest payments on the publicly held debt as a result of using the Social Security surplus to pay down the debt.

If the Social Security cash-flow surpluses are devoted to paying down the publicly held debt, the debt will be greatly reduced — and interest payments on the debt will fall sharply as a consequence. *If we save the Social Security surpluses, the amount the government will save in interest payments on the publicly held debt will more than offset the increased Social Security costs the government will incur in the next few decades as the baby boom generation begins to retire and Social Security costs rise.*

Consider the following figures. Interest payments on the publicly held debt today equal 2.0 percent of the Gross Domestic Product. Social Security expenditures equal 4.1 percent of GDP. If the Social Security surpluses are saved and the publicly held debt is paid down substantially — for example, to the level the Federal Reserve has suggested — interest payments on the publicly held debt will fall to 0.1 percent of GDP in 2020, a decline of 1.9 percent of GDP. Social Security costs are projected to reach 5.6 percent of GDP in that year, an increase of 1.5 percent of GDP over current levels. The decline of 1.9 percent of GDP in the cost of interest payments between now and 2020 thus will *exceed* the increase in the cost of Social Security benefits over this period.

In other words, the answer to the question of where the government will find the money to make increased interest payments to Social Security after 2016 — to cover the growing cost of benefits — is that the government will be able to use funds that have been freed up by the reduction in interest payments on the publicly held debt, which will have been caused in whole or in large part by devoting the Social Security reserves to debt reduction.

Preserving the Social Security surplus and dedicating it to debt reduction helps Social Security in another way as well. It increases national saving, which will result in a larger economy and, as a consequence, a larger flow of revenue to the federal government and the Social Security Trust Fund. A CBO analysis issued last year that contained projections through 2040 projected a larger economy and higher levels of revenues over the next four decades if the Social Security surplus is saved rather than consumed.

To be sure, modifications in Social Security are needed. Indeed, sooner or later, modifications will have to be made (with sooner being much better than later). Placing Social

**Declining interest costs help pay for increasing Social Security costs**
costs as a share of the economy (percent of GDP)

| | Costs in 2001 | Costs in 2020 | Change in costs, 2001-2020 |
|---|---|---|---|
| Social Security benefits and administration | 4.1% | 5.6% | 1.5% |
| Net interest on publicly held debt* | 2.0% | 0.1% | -1.9% |

* This analysis assumes that the publicly held is reduced to the level Federal Reserve Chairman Greenspan has suggested.

Security in a "lockbox" except in times when the economy is weak should, however, improve the ability of the government to finance Social Security's costs over the next few decades without placing as much strain on the rest of the budget.

## Conclusions

Measured over the next 75 years, the costs of the tax cut, if extended permanently, are more than twice as large as the shortfall in Social Security. Policymakers concerned about both the long-term fiscal health of the nation and the restoration of long-term Social Security solvency would do well to examine options for canceling some of the scheduled tax cuts before they take effect (particularly provisions narrowly targeted on those with the highest incomes) and using a portion of the resources as a downpayment in restoring solvency to the Social Security system. Canceling part of the tax cut could provide the resources for transferring some general revenues to Social Security. Such transfers are likely to be an essential ingredient of a sound Social Security reform package that makes changes in the Social Security program.

Without the resources consumed by the tax cut, the President's Social Security commission — and ultimately the Administration and Congress — are likely to have an exceedingly difficult time in fashioning a politically acceptable solution to the long-term Social Security deficit. In addition, if the tax cuts take effect as scheduled and are continued after 2010, the long-term drain on the budget will exceed the long-term benefit to the budget of eliminating the entire Social Security shortfall.